# 17.01 Accounting Changes: Principle & Estimate

ASC 250 defines an accounting change as a change in accounting principle, a change in estimate, or a change in the reporting entity. The correction of an error in previous financial statements (F/S) is not an accounting change.

The **three types** of accounting changes are:

1. Change in accounting principle
2. Change in accounting estimate
3. Change in reporting entity

ASC 250 is the result of a broader effort to improve the comparability of cross-border financial reporting by working with the *International Accounting Standard Board (IASB)* toward developing a single set of high-quality accounting standards.

## 1 - Change in Accounting Principle (Retrospective approach)

A change in accounting principle is:

- A change from one generally accepted principle to another one that is also generally accepted when there are two or more acceptable alternative accounting treatments.
- A change to a generally accepted principle when the one previous in use is no longer acceptable.
- A change in the method of applying an accounting principle.

An entity may only change an accounting principle if either the change is required as a result of an authoritative pronouncement or the entity can justify the change in that it is preferable. In many cases, authoritative pronouncements that require a change in accounting principles provide transition guidance indicating how the change is to be implemented. When provided, those guidelines are required to be followed.

A change in accounting principles, assuming no transition guidance is provided, is accounted for by applying the new principle **retrospectively**. This is accomplished as follows:

- The cumulative effect of the change on periods prior to the earliest period presented is reflected in the carrying values of assets and liabilities as of the beginning of the earliest period presented.
- An offsetting adjustment, if necessary, is generally made to the opening balance of retained earnings but may be to another component of equity or net assets, as appropriate.
- F/S for each period presented will reflect application of the new accounting principle.

**To account for the change in accounting principle under ASC 250:**

The F/S for all years impacted should be **retrospectively restated**. A retrospective application is the application of a different accounting principle to previously issued F/S, as if that principle had always been used. This is done as of the **beginning of the first period presented**.

1. F/S for each individual prior period presented are adjusted to reflect the **period-specific effects** of applying the new accounting principle.
2. An offsetting adjustment is made to the opening balance of retained earnings for that period (the beginning of the first period presented).

*Note that this change in treatment removes the accounting change from the Income Statement and moves it to the Statement of Retained Earnings.*

## Change from GAAP to GAAP

- Change in the valuation method for inventory (FIFO, etc.)
- Change to or from the full-cost method in the extractive industry
- Changes in construction accounting (ex: completed contract to percentage of completion).
    - A change in depreciation method is considered not distinguishable from a change in estimate and is treated as a change in estimate and accounted for on a *prospective basis*. It is called *a change in accounting principle inseparable from a change in accounting estimate.*

Only the **direct effects** of the change are recognized. An example of a direct effect is an adjustment to an inventory balance due to a change in inventory valuation method. Related changes, such as the effect on deferred taxes or impairment adjustment are also considered direct effects and must be recognized.

**Indirect effects** are any changes to current or future cash flows that result from making a change in accounting principle. An example of an indirect effect is a change in a profit sharing or royalty payment based on revenue or net income. Any indirect effects of the change are reported in the period in which the accounting change is made.

If it is impracticable to determine the cumulative effect to any of the prior periods, the new accounting principle is applied as if the change was made **prospectively** at the earliest date practicable.

**Footnote disclosures** to the F/S are required for a change in accounting principle. They include:

- The nature and reason for the change, and explanation as to why the new method is preferable
- The method of applying the change
- A description of the prior period information that is retrospectively adjusted
- The effect of the change on income from continuing operations, net income, and any other affected financial statement line item, and any affected per share amounts for the current period and all periods adjusted retrospectively
- The cumulative effect of the change on retained earnings or other components of equity or net assets as of the earliest period presented
- If retrospective application is impracticable, the reason, and a description of how the change was reported
- A description of the indirect effects of the change, including amounts recognized in the current period, and related per share amounts
- Unless impracticable, the amounts of indirect effect of the change and the per share amounts for each prior period presented

For example, showing both methods, assume a client operating on a calendar year used the weighted average method for inventory costing through the end of 20X1, and that ending inventory at 12/31/X1 was $700. In 20X2, the client changed to the FIFO method. Had FIFO always been in use, inventory at 12/31/X1 would have been $900.

Assume the change is also being made for tax purposes (if not, use Deferred tax liability instead of Current tax liability), and that the client's effective tax rate in 20X1 and 20X2 is 40%.

Since the change must be made as of the *beginning* of the fiscal year, an entry is required on 1/1/X2 to adjust inventory to the method and record the related tax effect:

| **Inventory** | **From Weighted Average** | **To FIFO** |
|---|---|---|
| 12/31/X1 | 700 | |
| 1/1/X2 | | 900 |

1. To record the change to the FIFO method of inventory costing using **ASC 250**, the following journal entry would be prepared in 20X2:

| | | |
|---|---|---|
| Inventory | 200 | |
| Current income tax liability | | 80 (200 × 40%) |
| **Retained Earnings** | | 120 (200 × 60%) |

2. To record the change to the FIFO method of inventory costing using **APBO 20 (old method)**, the following journal entry would be prepared in 20X2 (no longer GAAP):

| | | |
|---|---|---|
| Inventory | 200 | |
| Current income tax liability | | 80 (200 × 40%) |
| **Cumulative effect on prior years of accounting change (I/S)** | | 120 (200 × 60%) |

*Note that this change in treatment removes the accounting change from the Income Statement and moves it to the Statement of Retained Earnings.*

The tax effect of a change in principle occurs even if the change is not made for tax purposes. The only difference is that the tax effect will be reported as a deferred income tax liability instead of current.

If it is *impracticable* to determine the cumulative effect to any of the prior periods, the new accounting principle is applied as if the change was made **prospectively** at the earliest date practicable.

If, for example, a company changed inventory valuation from FIFO *to LIFO* and it is impracticable to determine the cumulative effect of applying this change retrospectively because records of inventory purchases and sales are no longer available for all prior years, then prior periods are presented as if it had carried forward the 20X0 ending balance in inventory (measured on a FIFO basis) and begun applying the LIFO method to its inventory beginning January 1, 20X1.

## 2 - Change in Accounting Estimate (Prospective Method)

A **change in estimate** has the effect of adjusting the carrying value of an existing asset or liability or affecting the subsequent accounting for existing or future assets or liabilities.

- Changes in accounting estimates result from the availability of new information.
- Examples may include credit losses (ie, bad debts); inventory obsolescence; sales discounts and sales returns and allowances, service lives and salvage values of depreciable or amortizable assets, and warranty obligations.

A change in accounting estimate is not applied to prior periods but is instead applied *prospectively*. It may affect the current period only, such as the writing off of a receivable that had not previously been reserved against; or may affect the current and future periods, such as a determination that a higher percentage of credit sales than expected are proving uncollectible.

It may be difficult to distinguish between a change in accounting principle and a change in accounting estimate, such as a change in the **method for depreciating or amortizing an asset**. Such a change is a change in the method of applying a generally accepted accounting principle, indicating it is a change in accounting principle. It is also recognition of the fact that the estimate of the pattern of benefits to be derived from the asset has changed. When *a change in accounting principle is inseparable from a change in accounting estimate*, it is accounted for as a **change in accounting estimate (prospectively)**.

**When making the change:**

1. Prior periods are NOT adjusted.
2. Current year, use the New Basis (new number of years, new percentages, etc.) and future periods if the change affects both. (called Prospective)

*Note: If the accounting change is inseparable from a change in principle, treat as a change in estimate.*

**Disclose** – the impact of the change on the current accounting period.

Since estimates, by their nature, are not exact figures, it can be expected that changes in estimate will occur on a continuous basis. As a result, no special reporting is needed: the new estimate is simply used from the **date of revision** onward. In the case of allowance accounts, the amount is simply adjusted with the other side of the entry being reported in continuing operations. For example, if the allowance for credit losses is revised, an entry to adjust the allowance will be offset by a change to the credit loss expense account. There are no special disclosures required.